



CRS Report for Congress

Tax Treatment of Employer Educational Assistance for the Benefit of Employees

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Summary

Educational assistance offered by employers to their employees may be exempt from federal income tax under Section 127 and Section 132 of the Internal Revenue Code. Section 127 is the employer educational assistance exclusion; Section 132, the fringe benefit exclusion for working condition benefits (e.g., job-related education) among other benefits. Congress established the two tax provisions well before it enacted other higher education tax benefits meant to assist taxpayers, their spouses, and dependents — regardless of employment status — pay current educational expenses incurred while obtaining postsecondary degrees and undertaking lifelong learning.

A recent focus of Congress has been to add provisions to the Internal Revenue Code (IRC) to help families cope with the rapidly escalating expenses of students pursuing college degrees. For example, the Lifetime Learning Credit (LLC) and the Hope Scholarship Credit were authorized permanently in the Taxpayer Relief Act of 1997.¹ Either credit may be claimed for the tuition and related fees of eligible taxpayers, their spouses, and dependents who are in their first two years of postsecondary education at eligible institutions and enrolled at least half-time in a program that grants a recognized credential.² The LLC also is available to eligible persons taking one or more courses at the undergraduate or graduate level to acquire or improve job skills. This added feature of the LLC allows it to be claimed for the tuition and fees not only of college juniors and seniors, but also of taxpayers, their spouses, and dependents undertaking lifelong learning

¹ For more information on benefits intended to help taxpayers meet current higher education expenses, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Linda Levine and Charmaine Mercer.

² Eligible educational institutions participate in student aid programs authorized under Title IV of the Higher Education Act, which include most colleges and universities as well as many proprietary (for-profit) trade schools.

to, for example, enter a new occupation or keep up-to-date the skills required to maintain their current positions.³

The tax benefits intended to help families pay higher education expenses at the time they are incurred joined longstanding provisions in the IRC whose eligible population is defined by its employment relationship. Employer educational assistance was initiated in the Revenue Act of 1979, and the working condition fringe benefit, in the Deficit Reduction Act of 1984.

According to the most recent data available, 49% of employees in the private sector had access to work-related educational assistance as part of the fringe benefit package offered by their firms. Many fewer workers (15%) had access to nonwork-related instruction in March 2007. Employees in management, professional, and related occupations; in full-time jobs; who belong to labor unions; with average earnings of at least \$15 per hour; and work at large firms (100 or more employees) are the most likely to have educational assistance benefits made available to them by their firms.⁴

Employers who offer their employees educational assistance can deduct its cost as a business expense in determining the firm's income tax liability. Empirical research suggests that employers gain from sponsoring employee education and training because it increases employee retention.⁵ Economists theorize that there is less investment in human capital than is optimal for society because the benefits of education extend beyond those who choose to undertake and pay for it (e.g., better health leading to lower Medicare costs). Thus, society also gains from employer-provided education to the extent it increases the educational attainment of the population and thereby compensates for the underinvestment in human capital.⁶

Any fringe benefits (i.e., non-wage compensation such as employer expenditures on health insurance) firms offer are taxable to employees unless, by law, the benefits are specifically excluded from gross income.⁷ Employer-provided educational assistance generally is included as part of taxable wages on the W-2 statements employers send to employees each January except in the instances discussed below.⁸

³ The deduction for higher education expenses also may be applied toward the tuition and fees associated with lifelong learning. The deduction was authorized temporarily in the Economic Growth and Tax Relief Reconciliation Act of 2001. It most recently expired on January 1, 2008.

⁴ U.S. Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007*, August 2007.

⁵ Peter Capelli, "Why Do Employers Pay for College?," *Journal of Econometrics*, vol. 121, 2004, and Colleen N. Flaherty, *The Effect of Tuition Reimbursement on Turnover*, National Bureau of Economic Research Working Paper 12975, March 2007.

⁶ CRS Report RL33238, *The Benefits of Education*, by Linda Levine.

⁷ For additional information on the taxation of fringe benefits, see U.S. Department of the Treasury, Internal Revenue Service, *Employer's Tax Guide to Fringe Benefits*, Publication 15-B.

⁸ This report does not cover tuition reduction, available through Section 117 of the IRC, because educational organizations can offer the benefit to more than current and former employees (e.g., dependent children and spouses of employees). Scholarships, which also may be tax-free under

The Employer Educational Assistance Exclusion

Congress authorized an exclusion from wages of up to \$5,250 annually at Section 127 of the IRC for

- employer payment or reimbursement of job- and nonjob-related educational expenses (including tuition and fees, books, supplies, and equipment) incurred by employees under a firm's qualified educational assistance program; and
- employer provision of job- and nonjob-related courses of instruction for employees (including the cost of books, supplies, and equipment) under such a program.

The \$5,250 limit has been in place since 1986. For employees of multiple employers with qualified educational assistance programs, the \$5,250 limit applies to the value of the benefit received from all employers.

The educational assistance exclusion was authorized at up to \$5,000 annually for five years as part of the Revenue Act of 1978 (P.L. 95-600), effective to December 31, 1983. Before 1979, employers could exclude from employee taxable income only job-related educational assistance under another provision of the IRC (discussed in the next section). The job-related requirement has been narrowly construed (e.g., training to maintain or improve skills so employees retain their current jobs). Consequently, the educational opportunities of employees in lower level positions have been limited compared to employees in higher level positions that typically have relatively broad job descriptions. Section 127 was intended, in part, to remedy this perceived inequity. The job-related requirement also means that firms must make determinations about whether each course taken by employees is very closely linked to their current positions — determinations with which the Internal Revenue Service (IRS) later might disagree. Section 127 thus simplified the tax code by enabling the exclusion from wages of expenses employees incur for virtually all education whether job-related or not.⁹

The temporary employer educational assistance provision has been extended, often retroactive to its expiration, on numerous occasions.¹⁰ Most recently, the Economic

⁸ (...continued)

Section 117 of the IRC, are not discussed as well because firms may establish grants for persons who lack an employment relationship with them (e.g., persons who reside in the community in which a business is located).

⁹ However, educational assistance does exclude payment for or provision of tools or supplies that employees may retain after the course is completed as well as meals, lodging or transportation. It also excludes reimbursement for courses involving sports, games, or hobbies unless related to the employer's business or the courses are required as part of a degree program.

¹⁰ The Education Assistance Programs (P.L. 98-611) reauthorized Section 127 from January 1, 1984, to December 31, 1985. The Tax Reform Act of 1986 (P.L. 99-514) further extended the provision from January 1, 1986, to December 31, 1987, while also raising the excludable maximum. Next, the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) reauthorized the exclusion from January 1, 1988, to December 31, 1988, and no longer covered

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Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) reauthorized the exclusion through December 30, 2010. EGTRRA also reinstated temporarily the exclusion for graduate school expenses, which last was eliminated in 1996.

For the Section 127 exclusion to apply, the employer must have a qualified educational assistance program. This is defined as a separate written plan that provides assistance exclusively to employees — not their spouses or dependents. At the employer's option, employees may be defined to include persons who have retired, left on disability or been laid-off; those on leave such as in the Armed Forces; a partner who performs services for a partnership; and a firm's owner if it is a sole proprietorship. The program must have restrictions against favoring highly compensated employees.¹¹ It also cannot provide more than 5% of payments to shareholders or owners and cannot offer employees a choice between taxable income and the education benefit. The firm must provide reasonable notice of the program to employees as well.

The educational assistance exclusion must be coordinated with other credits and deductions. In other words, employees cannot use the same educational expenses reimbursed through a Section 127 program as the basis for claiming other tax benefits. But, for example, employees whose employers have excluded \$5,250 in educational expenses from their wages may be able to claim the Lifetime Learning Credit for any remaining tuition and fees up to the credit's cap of \$10,000 per income tax return.

The Joint Committee on Taxation estimates that the revenue loss attributable to the employer education assistance exclusion may be approximately \$0.8 billion annually in FY2007 and FY2008, \$0.9 billion annually in FY2009 and FY2010, and \$0.2 billion in FY2011.¹²

¹⁰ (...continued)

formerly eligible graduate course work. The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) subsequently extended Section 127 from January 1, 1989, to September 30, 1990. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) then reauthorized the provision from October 1, 1990, to December 31, 1991, and again made graduate courses eligible. The Tax Extension Act of 1991 (P.L. 102-227) next extended the exclusion from January 1, 1992, to June 30, 1992, while the Omnibus Reconciliation Act of 1993 (P.L. 103-66) reauthorized it from its July 1, 1992, expiration date to December 31, 1994. The Small Business Job Protection Act of 1996 (P.L. 104-188) subsequently reauthorized the exclusion from January 1, 1995, to May 31, 1997, and once again made graduate courses ineligible after June 30, 1996. The Taxpayer Relief Act of 1997 (P.L. 105-34) then extended the provision to May 31, 2000; the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170), to December 31, 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) most recently extended and amended the tax provision as discussed in the above text.

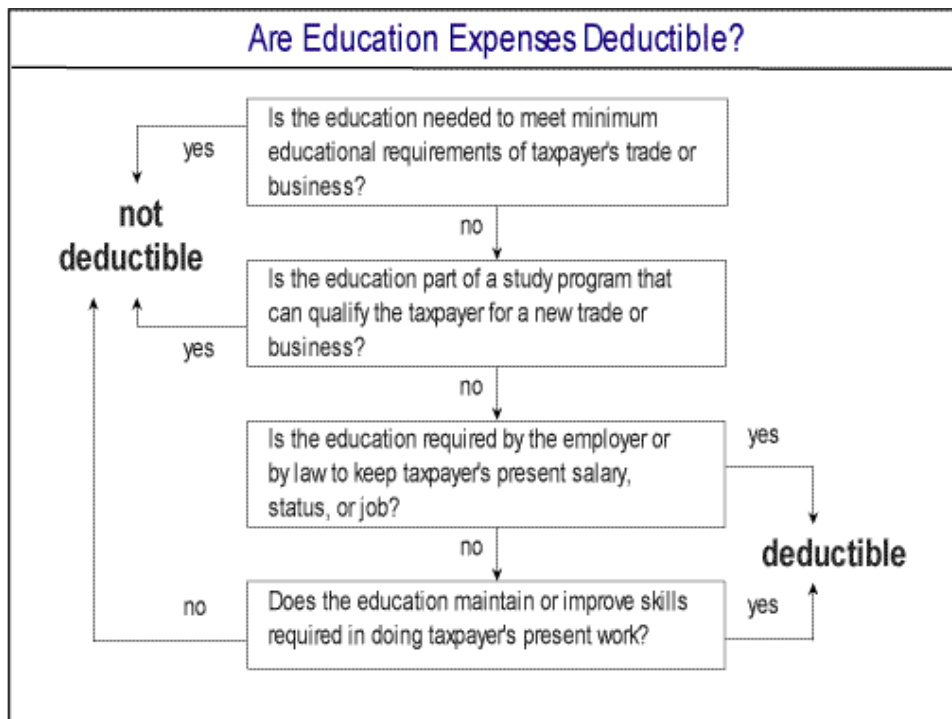
¹¹ The “nondiscrimination requirement” may cause the programs to be expensive if utilized by many employees. Employers are permitted to impose course completion or grade requirements, however. Similarly, they may require employees to remain on the payroll for some period after course completion. These allowable program features may limit its cost. In addition, employers are not required to fund existing educational assistance programs that effectively allows the companies to stop offering the benefit if they are in financial straits.

¹² Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*, JCS-3-07, 2007.

Job-Related Education: A Working Condition Fringe Benefit

If employers do not have a qualified educational assistance program or if they surpass Section 127's limit of \$5,250, employers still may exclude educational assistance from an employee's wages if the education or training qualifies as a working condition fringe benefit. Section 132 of the IRC allows certain fringe benefits to be exempt from an employee's taxable income (e.g., qualified employee discounts, moving expense reimbursement, working condition benefits).¹³ Working condition benefits are products or services employers provide to employees that employees could deduct as a business expense (Section 162) or depreciation expense (Section 167) on their individual tax returns had they paid for it.¹⁴

The IRS test for determining whether educational assistance is a deductible business expense essentially require courses to be job-related. The test consists of four questions displayed on the chart below. As shown in the bottom portion of the chart, education only is a deductible business expense if it is required by employers or by law for employees to retain their current jobs or salaries, or if the education maintains or improves the skills required for employees to perform their current jobs.



The employer may pay an employee's educational expenses directly to a school or indirectly through employee reimbursement. (Reimbursement must be through an accountable plan, which requires employees to substantiate their business expenses to the employer and return any amounts that exceed substantiated expenses within a reasonable

¹³ Congress amended the tax code to exclude certain fringe benefits from the taxable income of employees in the Deficit Reduction Act of 1984 (P.L. 98-369).

¹⁴ Examples of working condition benefits other than job-related education are outplacement services for terminated employees and use of demonstrator cars by auto sales personnel.

period of time.) Whether paid directly or indirectly, the educational assistance will be excluded from the earnings of employees on their W-2 statements, and the employees cannot apply these same expenses toward other credits or deductions on their individual income tax returns.

Unlike the Section 127 exclusion, the working condition fringe benefit generally does not require employers to have a separate written plan which means the benefit is exempt from a plan's nondiscrimination rules that restrict whom firms may assist. Under Section 132, then,

A company could, for example, offer the benefit to employees it wants to single out for special treatment or move quickly up the corporate ladder. Since [the lack of a written plan also means] there are no reporting requirements, there's no need to spread the word to other employees.¹⁵

Courses may be taken at the undergraduate and graduate levels under both Section 127 and Section 132.¹⁶ The two provisions allow deductions for tuition and related fees, books, supplies, tools and equipment, but Section 132 also allows the deduction to apply to meals, lodging, and transportation expenses if the employee travels from home to obtain the education. Unlike the \$5,250 limit on educational assistance under Section 127, the value of the working condition fringe benefit is not capped.

Both sections of the IRC may be offered to employees, but not their spouses or dependents. The definition of employee differs, however. Current employees; employees who have retired, left on disability or been laid-off; a partner who performs services for a partnership; and a firm's owner if it is a sole proprietorship may be eligible under Section 127. Current employees, a partner who performs services for a partnership, a director of a company, and an independent contractor who performs services for a firm may be eligible under Section 132.

The job-related educational expenses of employees that are reimbursed under a nonaccountable plan are included in their gross income. Nonetheless, employees may be able to deduct them on their own income tax returns as a business expense under Section 162. Those employees who itemize deductions on Schedule A (Form 1040) may deduct educational assistance from taxable income provided the education meets the IRS test depicted in the chart above and the educational assistance plus other miscellaneous deductions exceed 2% of adjusted gross income.¹⁷ Thus, taxpayers who do not exceed the 2% floor may be unable to offset any or all of the tax on nonexcludable educational assistance. And, taxpayers who do not itemize deductions do not have this opportunity available to them.

¹⁵ Edmund D. Fenton Jr., "Employer-Provided Education Benefits: Section 132(d) Is Worth a Second Look," *Journal of Accountancy*, vol. 198, September 2004.

¹⁶ Section 127's coverage of graduate education ends after December 31, 2010, in accordance with EGTRRA's sunset provision.

¹⁷ Deductible education expenses are tuition, books, supplies, lab fees, and similar items; certain transportation and travel costs; and other expenses (e.g., cost of researching and writing a report as part of an educational program). For more information, see U.S. Department of the Treasury, Internal Revenue Service, *Tax Benefits for Education*, Publication 970.